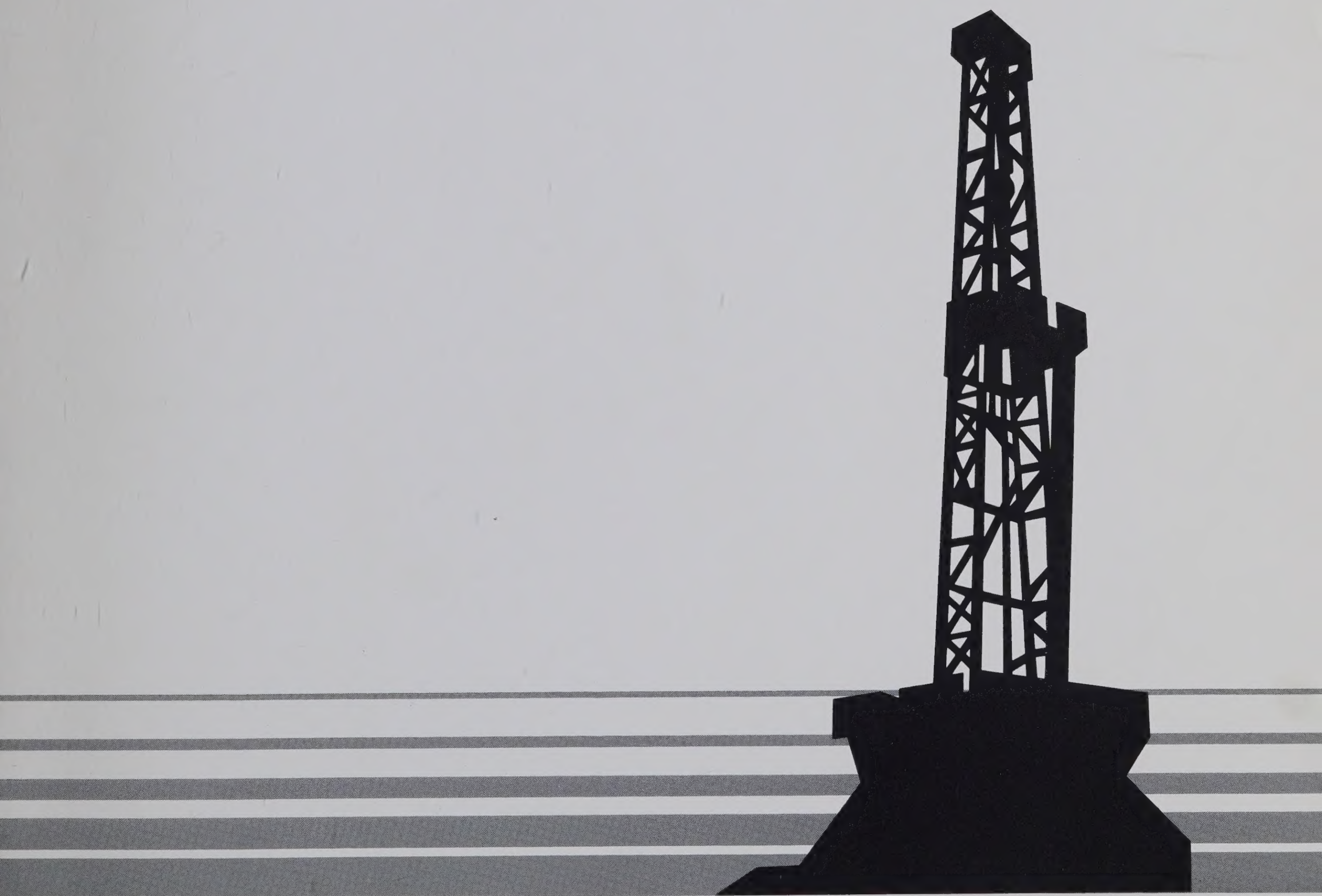
KNEE HILL ENERGY CANADA LTD.



1987
ANNUAL REPORT

CORPORATE PROFILE

Knee Hill Energy Canada Ltd. was formed in February 1987, upon the amalgamation of Knee Hill Energy Ltd. (Incorporated 1904) and Madison Oil and Gas Limited (Incorporated 1926).

Knee Hill's shares are publicly traded and listed on the Alberta Stock Exchange under the symbol K H C.

The Company is engaged in the business of producing, developing, exploring for and acquiring oil and natural gas interests, primarily in Alberta. Knee Hill prefers to operate the properties in which it has an interest.

Knee Hill's principal source of income is derived from its working and royalty interests in oil and natural gas production.

ANNUAL GENERAL MEETING

Highwood Room
Delta Bow Valley Hotel
209 - 4th Avenue S.E.
Calgary, Alberta
11:00 a.m.
Monday, July 18, 1988

TABLE OF CONTENTS

Neutral Hills East — pumping Dina oilwells — directionally drilled under Lake

FINANCIAL AND OPERATING SUMMARY

	Year Ended December 31	
	1987	1986
FINANCIAL ($000s except per common share data)		
Production revenue	**3,550**	1,832
Cash flow	**1,804**	145
Loss for the year	**(1,909)**	(511)
Per common share		
Cash flow	**$ 0.23**	$ 0.03
Loss for the year	**$(0.25)**	$(0.11)
Capital expenditures	**3,633**	5,514
Long term debt	**3,850**	4,250
Shareholders' equity	**8,899**	8,295
Common shares outstanding, basic	**9,181**	5,512
Common shares outstanding, average	**7,713**	4,642
OPERATING		
Production		
Oil — barrels	**129,037**	77,213
— barrels per day	**354**	211
Gas — thousand cubic feet	**380,527**	416,262
— thousand cubic feet per day	**1,043**	1,140

1987 REPORT TO SHAREHOLDERS

We are pleased to be able to inform you of the progress Knee Hill Energy Canada Ltd. (Knee Hill) made in 1987 and of its plans for 1988.

Knee Hill was formed in February 1987 upon the amalgamation of Madison Oil and Gas Limited and Knee Hill Energy Ltd., against a backdrop of instability in energy prices and weakness in equity markets.

1987 Review

Operations — Knee Hill was very active in 1987 participating in the drilling of 33 wells, 25 of which were Company operated. Knee Hill experienced a 70% success rate in its drilling program. The program discovered a new oil pool and drilled 3 delineation wells at Neutral Hills West as well as drilling 10 development wells at Neutral Hills East. During 1987 Knee Hill and its partners constructed a central battery facility at Neutral Hills East which has a design capacity of 3,000 BOPD and which was averaging 1,600 BOPD at the end of 1987 and is averaging 2,100 BOPD at the date of writing this report.

— In addition to operating a number of wells and facilities for its industry partners Knee Hill also operates an internal joint venture for The Inuvialuit Petroleum Corporation (IPC), an industry partner who is also its controlling shareholder.

Financial — Cash available to Knee Hill in 1987 from operations increased $1,658,249 to $1,803,645 from $145,396. During the year Knee Hill successfully completed a private placement to the IPC and a rights offering to its shareholders which combined to raise in excess of $1,100,000.

— The cancellation of a planned flow through share offering in October 1987 due to the stock market crash combined with much weaker natural gas prices during 1987 and a softening of oil prices in the fall of 1987 put financial pressure on Knee Hill notwithstanding its tremendously improved performance in 1987.

— Effective April 1, 1988 and subject to regulatory, lender and shareholder approvals and to obtaining a fair value opinion letter from independent engineering evaluators the Board of Directors of Knee Hill has approved the sale of certain of the Company's oil and natural gas assets to realize $3,018,000. Proceeds of the sale will be used to retire a substantial portion of the Company's debt.

— A review of the Company's reserves in compliance with the guidelines issued by the Canadian Institute of Chartered Accountants has resulted in a ceiling test write down of $2,197,000 resulting in an overall loss for the year after taxes of $1,908,698. The guidelines require that the calculation of future net revenues from proven reserves be based on current oil and gas prices less estimated financing costs and general and administrative expenses. This write-down will result in reduced depletion charges and will therefore impact positively on the Company's reported profits in future years.

— Before the write-down and after deferred taxes of $340,000 Knee Hill would have had net income for 1987 of $288,302 compared to a loss of $511,319 for the preceding year.

1988 and The Future

Goals — Sell off identified assets and apply the proceeds to debt reduction with the result that such asset sales will not have a significant impact on Knee Hill's anticipated 1988 cash flow.

— Through an ongoing development drilling program and by tie-in of shut-in natural gas reserves, replace any cash flow lost due to the sale of identified assets.

— Find sufficient proven reserves in 1988 to replace reserves produced in 1988. And, add to the Company's reserve base through drilling, asset acquisition or merger.

— Focus on internally generated exploration prospects which Knee Hill will operate and in which it will seek to retain a larger working interest.

— Continue to rationalize the Company's smaller working interest properties and continue to reduce its per unit production costs.

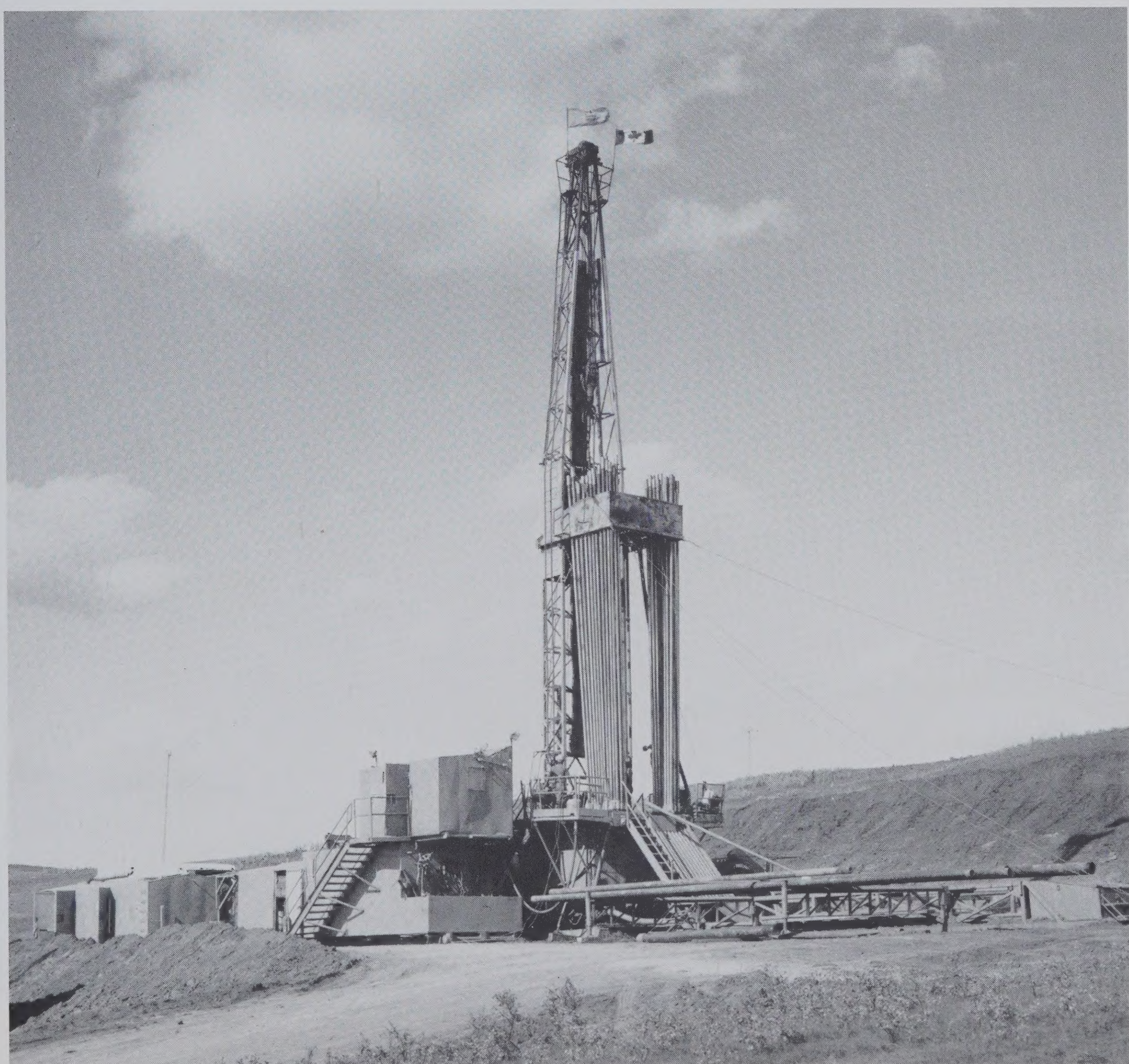
— Continue to manage third party oil and gas assets for an administration fee and continue the Knee Hill/IPC Joint Venture.

Operations — Knee Hill will be operating a twelve well development and field extension drilling program at Neutral Hills commencing immediately. Seven of the wells are in the East pool and five are in the West pool. Following evaluation of the drilling results at the Neutral Hills West property a central battery facility will be constructed.

— I'd like to say a special thank you to all Knee Hill's employees whose commitment and hard work has been so instrumental in helping the Company evolve to its present stage. Also, thanks to the members of Knee Hill's Board of Directors for their advice, direction and encouragement.

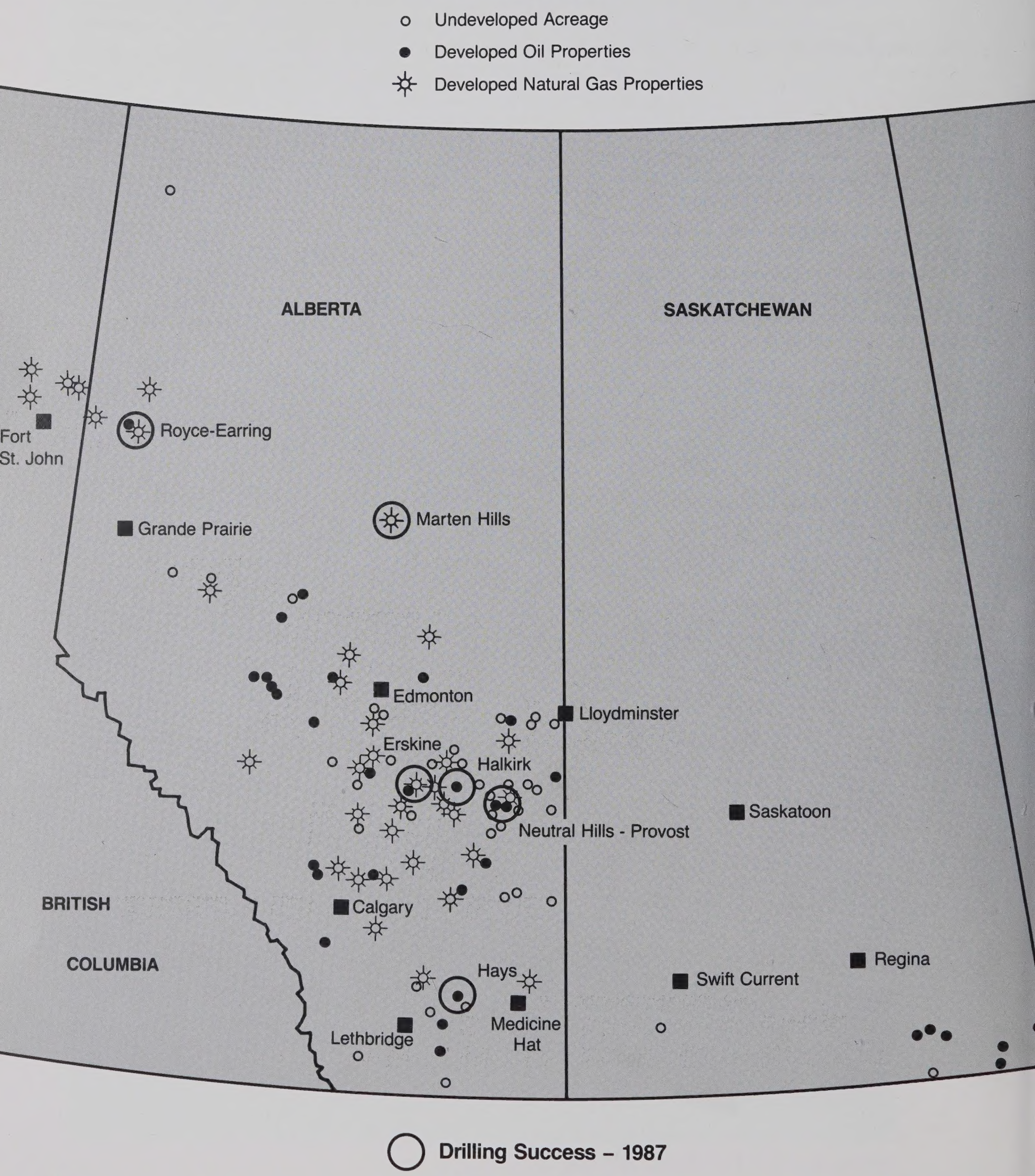
Respectfully submitted,

P. Douglas McArthur
President
May 12, 1988



Drilling 8D-11-37-7 W4M Neutral Hills East

EXPLORATION & PRODUCTION AREAS WESTERN CANADA



REPORT ON OPERATIONS

Highlights — 1987

Knee Hill Energy Canada Ltd. experienced a dramatic increase in production and net operating revenues due to:

— successful Knee Hill operated development program in Neutral Hills

— discovery of new Dina oil reservoir in Neutral Hills West

— amalgamation and integration of Madison Oil and Gas Limited operations

— completion of Knee Hill operated major battery facility at Neutral Hills East

Outlook — 1988

Knee Hill will continue to concentrate on the factors that have led to its success in 1987:

— operate prospects and projects whenever feasible

— internally generated prospects — high productivity, high reserve prospects yielding early cash flow

— direct its activities towards southern Alberta and primarily in the Provost-Neutral Hills areas

— acquire undeveloped acreage at reasonable prices

— maintain larger working interests whenever possible

— rigid economic criteria must be met by all projects

Drilling Summary

	Oil	Gas	Service	Dry	Total
Gross Wells	17	4	2	10	33
Net Wells	2.439	0.541	0.237	2.015	5.232

During the past year Knee Hill participated in a total of thirty-three wells. Of these, seventy-five percent were operated by the Company and fifty-eight percent were classified as development wells. Seventeen wells were completed for oil potential and four as natural gas wells. Two of the wells were cased for future water disposal purposes.

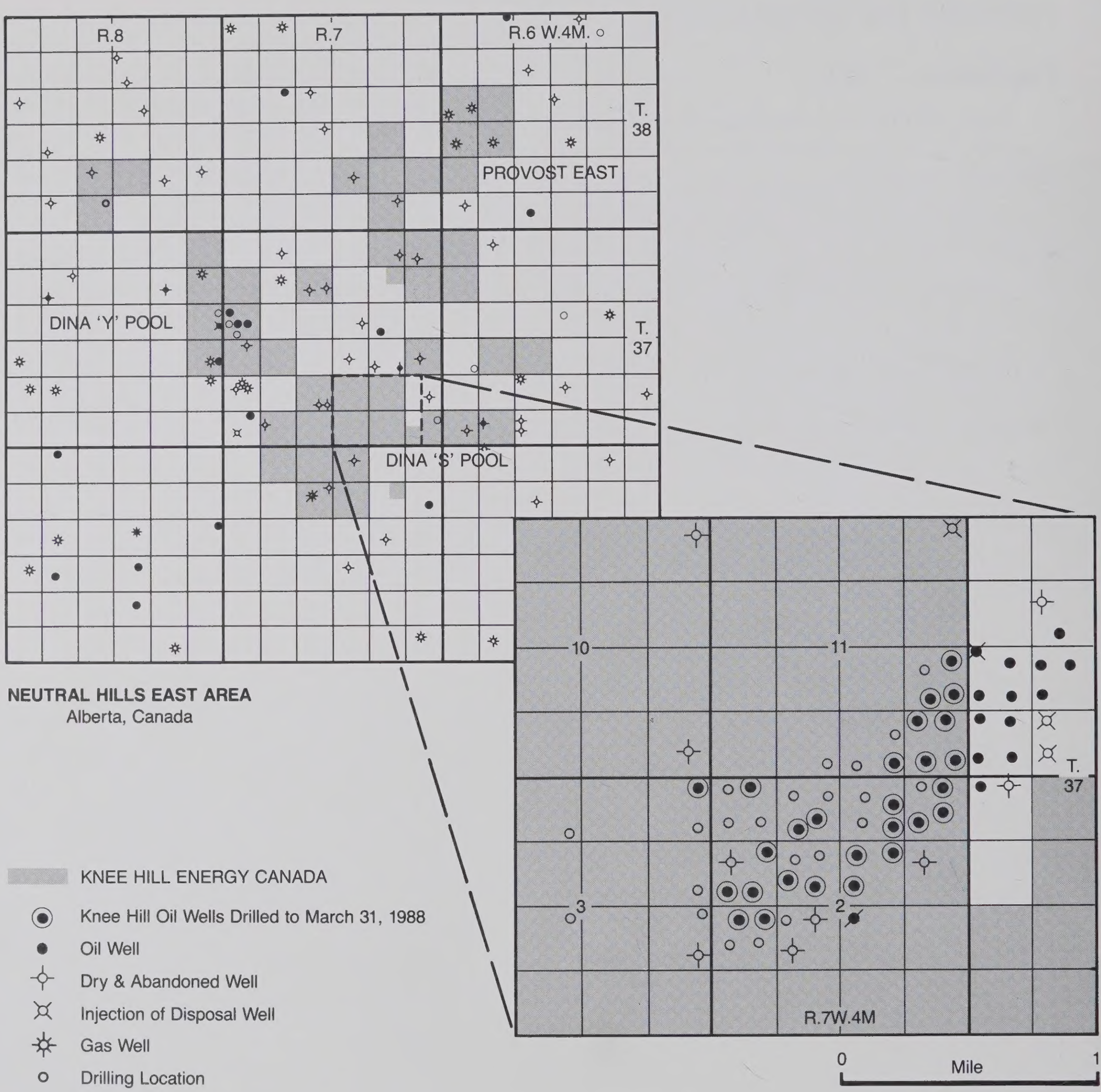
The overall success rate for 1987 drilling activity was seventy percent. Knee Hill's working interest in the year's activity averaged sixteen percent.

Production Summary

Knee Hill has interests in six producing oil and gas units, ninety-nine oil wells and eighty-eight gas wells. The Company operates a total of sixty-nine of these wells.

Daily oil production during the 1987 fiscal year averaged 354 barrels per day. Natural gas production averaged 1,043 thousand cubic feet per day.

Neutral Hills East Battery — oil treatment facility



NEUTRAL HILLS EAST AREA
Alberta, Canada

- KNEE HILL ENERGY CANADA
- Knee Hill Oil Wells Drilled to March 31, 1988
- Oil Well
- Dry & Abandoned Well
- Injection of Disposal Well
- Gas Well
- Drilling Location

AREAS OF ACTIVITY

Overview

Eighty-eight percent of Knee Hill's activity in 1987 was focused in the southern Alberta area. Successful development took place in the Neutral Hills (Dina oil), Hays (Sawtooth oil) and Erskine (Glauconite gas) areas. Exploratory successes were achieved in the general Neutral Hills - Provost areas (Dina oil and Colony gas) and in the Halkirk East area (Dina oil).

In northern Alberta the Company participated in drilling two Charlie Lake oil wells in the Royce-Earring area and a natural gas development well was drilled at Marten Hills.

During the year Knee Hill participated in the shooting or acquisition of over two hundred miles of seismic data, primarily in the Neutral Hills - Provost region.

Neutral Hills - Provost

This area of southern Alberta has come into focus during 1987 with several Basal Mannville - Dina Sand oil discoveries. Knee Hill, with working interests in over fifty sections, is a major player in this area. The Dina prospect has been referred to by some operators as the best exploration play in the province. Low to moderate drilling depths and costs, multi-zone prospects, and above-average production rates combined with ease of access and marketability make this one of the "hot" areas of Alberta.

Neutral Hills East - Dina "S" Pool

In the first quarter of 1987, approval was granted by the Energy Resources Conservation Board for a reduction to ten-acre drilling spacing units. The pool was placed on Good Production Practice (GPP) status effective March 1, 1987. During the year an additional ten development oil wells were drilled and all are on production. Seven more wells were drilled in the first quarter of 1988 and it is anticipated a further ten wells will be drilled prior to year-end. A major battery facility was constructed by Knee Hill during the year and became fully operational in September. The Knee Hill operated portion of this pool was producing approximately 1,600 barrels of oil per day from twenty wells at year end. The Company has interests averaging sixteen percent in this pool.

Neutral Hills West - Dina "Y" Pool

During the year Knee Hill operated the discovery well which was drilled into this new pool and followed up with three outpost successes. One of these wells may be converted to a water disposal well. While detailed results of these wells have not been released by the partners, Knee Hill anticipates that this pool will have the same aerial extent as the Dina "S" Pool. The Company has a fifteen percent working interest in this venture. Aggressive development of this pool is anticipated during the 1988 fiscal year in order to take advantage of CEDIP credits and Alberta Crown royalty holidays.

Provost East - Colony Gas

Two wells having Colony sand natural gas potential were drilled during 1987. It is anticipated that gas sales from these wells will commence in the current fiscal year. The 8-19 well tested natural gas at rates of 2.77 million cubic feet per day while the 6-17 well tested at 2.81 million cubic feet per day. Knee Hill has interests varying from 5.75% to 19.5% in this area.

ACREAGE AND RESERVES

Land Holdings (Acres):

	Producing		Undeveloped	
	Gross	Net	Gross	Net
Alberta	41,722	6,724	100,911	23,690
British Columbia	3,355	334	3,766	176
Saskatchewan	708	56	1,925	195
TOTAL	45,785	7,114	106,602	24,061

Reserve Summary (As of December 31, 1987)

Before Income Tax

Value of Reserves and Undeveloped Land (Thousand $)

	Undiscounted	15%	20%
Proven	53,606	14,532	11,376
Probable	1,609	207	124
Land	1,646	1,646	1,646
TOTAL	56,861	16,385	13,146

Outlook

Knee Hill expects to participate in forty drilling locations during 1988 and will operate eighty-six percent of these. Ninety-seven percent of the Company's drilling efforts will be concentrated in Southern Alberta. The Company will retain larger working interests in new prospects generated during the coming year.

Knee Hill has interests in 35,000 acres in the "hot" Dina prospect area around Neutral Hills. The Company anticipates that these lands will provide for the future growth of Knee Hill.

A major focus of the Company's technical staff and management during the current year will be to secure markets for shut-in natural gas and bring these reserves on-stream.

Net Reserves of Oil and Natural Gas Liquids

(Thousands of Barrels)

Proven	814
Probable	3
TOTAL	817

Net Reserves of Gas

(Million Cubic Feet)

Proven	10,717
Probable	362
TOTAL	11,079

Financial Review

Knee Hill Energy Canada Ltd. has completed a fiscal year of substantial change, including a corporate amalgamation and the reorganization of interests held by the controlling shareholder, the Inuvialuit Petroleum Corporation.

Cash flow from operations in 1987 increased to $1,804,000 or $0.23 per share from $145,000 or $0.03 per share in 1986. Increased revenues from oil and gas production, management fees and interest and a reduction in general and administration expenses were the reasons for this dramatic cash flow increase.

A loss of $1,909,000 or $0.25 per share was incurred compared with a loss of $511,000 or $0.11 per share for 1986. The loss for 1987 was due to the write-down in the carrying value of Knee Hill's assets in compliance with the Full Cost Accounting guidelines of the Canadian Institute of Chartered Accountants. The write-down amounted to $2,197,000 or $0.28 per share. This write-down will result in lower depletion charges on the Statement of Operations in future years.

The December 31, 1987 working capital deficiency of $178,000 is down considerably from the $732,000 deficiency at the same time last year. Long term debt has declined $400,000 in accordance with the Company's goal to improve the financial position.

Knee Hill successfully completed a rights offering together with a private placement of common shares to the shareholders in 1987 which raised in excess of $1,100,000.

The deferred charges recorded in 1986 were costs associated with the amalgamation and have been recorded as a reduction of capital stock, net of deferred tax, of $216,000 in 1987.

Since the end of Knee Hill's 1987 fiscal year, $3,018,000 of properties have been sold to the Inuvialuit Petroleum Corporation, subject to certain regulatory, lender and shareholder approvals. The proceeds of sale will be applied to reduce the debt of the Company and will eliminate the working capital deficiency.

Outlook for 1988

Oil and gas prices are currently substantially lower than the average 1987 prices and interest rates are higher. The recent sale of assets and reduction in debt and debt service together with the program of development drilling should assist in shielding the Company from these economic fluctuations in the future.

Construction of Neutral Hills East Battery Facility

KNEE HILL ENERGY CANADA LTD.

CONSOLIDATED BALANCE SHEET

	December 31 1987	1986
ASSETS		
CURRENT ASSETS		
Cash	**$ 253,602**	$ 260,828
Marketable securities, at market value	**19,214**	5,000
Accounts receivable	**1,110,003**	473,862
Government incentives receivable	**955,451**	51,176
Prepaid expenses and deposits	**24,649**	11,066
	2,362,919	801,932
FIXED ASSETS (Notes 2 and 9)	**13,178,770**	12,917,940
DEFERRED CHARGES (Note 4)	**—**	432,341
	$15,541,689	$14,152,213
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Demand bank loan	**$ —**	$ 50,000
Accounts payable and accrued liabilities	**1,840,667**	1,425,408
Due to shareholder (Note 8)	**700,000**	58,536
	2,540,667	1,533,944
LONG TERM DEBT (Note 3)	**3,850,000**	4,250,000
DEFERRED INCOME TAXES	**252,000**	73,000
SHAREHOLDERS' EQUITY		
CAPITAL STOCK (Note 4)		
First preferred	**1,938,110**	1,938,110
Common	**11,844,303**	9,331,852
	13,782,413	11,269,962
DEFICIT	**(4,883,391)**	(2,974,693)
	8,899,022	8,295,269
	$15,541,689	$14,152,213

APPROVED BY THE BOARD:

P. Douglas McArthur

Director

Director

KNEE HILL ENERGY CANADA LTD.

CONSOLIDATED STATEMENT OF OPERATIONS AND DEFICIT

	Year Ended December 31 1987	1986
REVENUE		
Oil and gas sales	**$ 3,550,009**	$ 1,832,058
Management fees and interest	**255,755**	57,569
	3,805,764	1,889,627
EXPENSES		
Production	**1,053,818**	540,339
General and administrative	**570,851**	813,515
Interest on long-term debt	**377,450**	390,377
	2,002,119	1,744,231
CASH FLOW FROM OPERATIONS	**1,803,645**	145,396
OTHER CHARGES		
Depletion and depreciation	**1,175,343**	715,715
Write-down of fixed assets (Notes 2 and 9)	**2,197,000**	—
	3,372,343	715,715
LOSS BEFORE INCOME TAXES	**(1,568,698)**	(570,319)
DEFERRED INCOME TAXES (Note 5)	**340,000**	(59,000)
LOSS	**(1,908,698)**	(511,319)
DEFICIT AT BEGINNING OF YEAR	**(2,974,693)**	(2,463,374)
DEFICIT AT END OF YEAR	**$(4,883,391)**	$(2,974,693)
LOSS PER COMMON SHARE (Note 6)		

AUDITORS' REPORT

To the Shareholders of
Knee Hill Energy Canada Ltd.

We have examined the consolidated balance sheet of Knee Hill Energy Canada Ltd. as at December 31, 1987 and the consolidated statements of operations and deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1987 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Thorne Ernst & Whinney

Chartered Accountants

April 15, 1988
(May 2, 1988
as to note 9)

KNEE HILL ENERGY CANADA LTD.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

	Year Ended December 31 1987	1986
CASH PROVIDED BY (USED FOR):		
OPERATIONS		
Loss	**$(1,908,698)**	$ (511,319)
Items not involving cash		
Depletion and depreciation	**1,175,343**	715,715
Deferred income taxes	**340,000**	(59,000)
Write-down of fixed assets	**2,197,000**	—
	1,803,645	145,396
Change in non-cash operating working capital	**(1,211,490)**	499,162
	592,155	644,558
FINANCING		
Sale of royalty interests	**—**	770,000
Increase (decrease) in long-term debt	**(400,000)**	520,000
Conversion of preferred shares	**—**	(188,526)
Adjustment to preferred shares	**—**	(45,005)
Deferred charges	**432,341**	(432,341)
Issue of common shares	**2,351,451**	4,402,387
Shareholder loans	**700,000**	—
	3,083,792	5,026,515
CAPITAL EXPENDITURES		
Fixed assets	**(3,864,613)**	(6,378,935)
Government incentives	**231,440**	865,205
	(3,633,173)	(5,513,730)
INCREASE IN CASH	**42,774**	157,343
CASH AT BEGINNING OF YEAR	**210,828**	53,485
CASH AT END OF YEAR	**$ 253,602**	$ 210,828
CASH IS COMPRISED OF:		
Cash	**$ 253,602**	$ 260,828
Demand bank loans	**—**	(50,000)
	$ 253,602	$ 210,828

KNEE HILL ENERGY CANADA LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1987

Summary of Significant Accounting Policies

CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary Nimus Resources Inc.

FIXED ASSETS

The Company follows the full cost method of accounting whereby all costs related to the acquisition, exploration and development of petroleum and natural gas reserves are capitalized into separate cost centres on a country by country basis (currently only Canada). Such costs include land acquisition costs, geological and geophysical expenses, carrying charges of non-productive properties and costs of drilling both productive and non-productive wells.

Overhead is not capitalized other than to the extent of the Company's working interest in operated capital expenditure programs to which operator's fees have been charged pursuant to standard industry operating agreements. Accordingly, capitalized costs on operated programs are equivalent to those on non-operated programs. Interest is not capitalized.

Sales of oil and gas properties are accounted for as adjustments of capitalized costs with no gain or loss recognized, unless such adjustments would significantly alter the relationship between capitalized costs and proven reserves of the cost centre.

Petroleum incentives which are earned by the Company pursuant to legislation enacted by the Federal and Alberta Governments are reflected as a reduction of the cost of the related assets. Certain prior years' expenditures have been incurred by the Company for shareholders pursuant to agreements in consideration for the amounts of the expenditures and the ascribed consideration of the related shares issued have been reduced by the petroleum incentives earned by the shareholders.

DEPRECIATION AND DEPLETION

The costs related to a cost centre from which there is production, together with the costs of related production equipment, are depleted and depreciated on the unit of production method based on the estimated gross proven reserves of each cost centre as determined by independent engineers. Natural gas reserves and production are converted into equivalent barrels of oil based upon the relative energy content of each product.

The cost of other equipment is depreciated using the declining balance method at rates ranging from 10% to 30%. These rates are designed to amortize the cost of the equipment over the estimated useful life.

The ceiling limitation of capitalized costs is determined by comparing the net book value of the oil and gas properties less recorded deferred taxes to the sum of the following:

(i) The undiscounted future net revenue from the proven reserves less estimated interest, general and administrative expenses and income taxes; and

(ii) unproven properties at the lower of cost or estimated fair value.

Future net revenue is calculated using oil and gas prices and costs, Alberta Royalty Tax Credit and Income Tax legislation in effect at the year end date.

JOINT VENTURE ACCOUNTING

Substantially, all of the exploration, development and production activities of the Company are conducted jointly with others. These financial statements reflect only the Company's proportionate interest in such activities.

REVENUES FROM OIL AND GAS

Revenues from oil and gas sales are stated net of all royalties and include the Alberta Royalty Tax Credit.

SEGMENTED INFORMATION

The Company's activities are primarily in one business segment, oil and gas exploration, development and production, and are conducted in Canada.

1. **Amalgamation**

Knee Hill Energy Ltd. (Knee Hill) and Madison Oil and Gas Limited (Madison) amalgamated effective February 27, 1987 pursuant to a shareholder approved plan of arrangement which provided for one share of Madison to be issued for every three shares of Knee Hill. Madison changed its name to Knee Hill Energy Canada Ltd.

The amalgamation has been accounted for as a pooling of interests and is summarized as follows:

	Madison	Knee Hill	Total
Book value of assets	$6,910,986	$7,510,344	$14,421,330
Book value of liabilities	1,290,080	4,226,450	5,516,530
	$5,620,906	$3,283,894	$ 8,904,800
Issued capital stock held by the shareholders of the amalgamating companies at the amalgamation date	2,994,460	3,791,787	6,786,247

2. **Fixed Assets**

	1987			1986
	Cost	Accumulated depletion and depreciation	Net book value	Net book value
Petroleum and natural gas leases and rights, including exploration, development and equipment thereon	$17,011,212	$3,967,565	$13,043,647	$12,845,756
Equipment, furniture and leasehold improvements	333,816	198,693	135,123	72,184
	$17,345,028	$4,166,258	$13,178,770	$12,917,940

The $2,197,000 write-down of petroleum and natural gas properties is related to the reduction in value resulting from the ceiling limitation calculation (Note 9).

3. **Long Term Debt**

	1987	1986
Demand production loan	$3,850,000	$4,250,000

The Company has a $4,950,000 line of credit with a major Canadian bank. The line of credit is comprised of an operating facility of $300,000 which bears interest at the lenders prime rate plus ½ of 1% per annum, and a revolving production facility of $4,650,000 which bears interest at the lenders prime rate plus ⅝ of 1% per annum. The production facility is subject to annual review by the lender and a principal repayment schedule to commence in January, 1989.

The line of credit is secured by assignment of properties, investments and receivables, a letter of undertaking not to dispose of any properties without the prior consent of the lender and an $8,000,000 floating charge demand debenture.

4. **Capital Stock**

(a) Authorized

The authorized capital stock of the Company consists of:

(i) An unlimited number of no par value common shares.

(ii) An unlimited number of no par value convertible, redeemable first preferred shares issuable in series. The shares may be converted by the holders to common shares on a one to one basis. The shares are redeemable by the Company after January 1, 1990. The following summarizes the details of the authorized number of first preferred shares:

	Series 1	Series 2	Series 2A	Series 3	Series 3A
Authorized number of shares	240,000	240,000	800,000	240,000	200,000
Price per share:					
Stated issue	$2.50	$3.20	$3.00	$4.00	$3.40
Redemption	$2.90	$3.70	$3.40	$4.60	$3.90
Conversion	$2.50	$3.20	$3.00	$4.00	$3.40

(iii) 1,000 12% second preferred shares, cumulative, convertible, redeemable with no par value. The shares are convertible at the option of the holder at the rate of 200 common shares for each second preferred share. There are no second preferred shares outstanding.

(b) Issued

The quantities of shares described have been adjusted to reflect the ratio of common shares issued on the amalgamation of February 27, 1987.

	First Preferred		Common	
	Number	Amount	Number	Amount
Balance, December 31, 1985	1,102,842	$2,171,641	3,772,327	$ 4,874,465
Issued for cash				
Stock options			9,000	7,870
Adjustment to government incentives		(45,005)		
Conversion of preferred shares	(62,842)	(188,526)	71,298	188,526
Conversion of note payable			166,667	175,000
Purchase of assets			1,492,800	4,085,991
Balance, December 31, 1986	1,040,000	$1,938,110	5,512,092	$ 9,331,852
Issued for cash				
Private placement			1,274,155	637,077
Stock options			175,000	113,750
Rights offering			968,209	484,105
Purchase of Assets			1,251,929	1,752,700
Share Issue Expenses net of deferred taxes of $216,000				(475,181)
Balance, December 31, 1987	1,040,000	$1,938,110	9,181,385	$11,844,303

At December 31, 1987 and 1986 240,000 Series 1 and 800,000 Series 2A first preferred shares are issued and outstanding.

The deferred charges recorded in 1986 pertain to costs incurred for the amalgamation. In 1987 these charges have been recorded as a reduction of capital stock.

(c) Stock Options

Balance, December 31, 1986 (at prices ranging from $0.65 to $0.85)	261,000
Granted (at $0.85 per share)	196,000
Exercised (at $0.65 per share)	(175,000)
Expired (at prices ranging from $0.65 to $0.85)	(61,000)
Balance, December 31, 1987	221,000

Stock options are issued to officers and employees. Under the terms of the agreements 25 per cent of the options vest on the anniversary dates and are exercisable for five years after vesting at $0.85 per share. Options on 25,000 shares expired on January 31, 1988.

(d) Warrants

A warrant to purchase 75,000 common shares at $0.75 per share on or before January 11, 1989 was issued in conjunction with the Rights Offering of July, 1987.

5. Deferred Income Taxes

The reconciliation of the difference between the deferred income taxes recorded and the deferred income taxes obtained by applying the tax rate to the loss before income taxes is as follows:

	1987	1986
Tax rate applied	46%	46%
Computed deferred income taxes	($721,601)	($262,347)
Increase (Decrease) in income taxes resulting from:		
Tax benefit of loss carry forward not recognized	—	61,950
Non-deductible crown payments, net	108,666	17,611
Non-deductible depletion	261,510	159,839
Resource allowance	(294,515)	(12,246)
Other	(24,680)	(23,807)
Write-down of fixed assets	1,010,620	—
	1,061,601	203,347
Deferred income taxes	$340,000	($59,000)

The Company has issued preferred flow through shares in exchange for expenditures on fixed assets and common shares to acquire other assets. As a result, at December 31, 1987, costs of $5,486,000 ($8,252,000 at December 31, 1986) are not deductible for tax purposes. The effect on deferred taxes is shown above as non-deductible depletion and write-down of fixed assets.

6. Loss Per Share

	1987	1986
Basic loss per common share	($0.25)	($0.11)

Fully diluted loss per common share has not been used as the conversion of the preferred shares would not be dilutive.

7. Commitments

The Company has an office lease arrangement with an aggregate annual rental of $116,500 until April, 1992.

8. Related Party Transactions

The following transactions were entered into with the Inuvialuit Petroleum Corporation, the controlling shareholder of the Corporation, during 1987:

(i) 1,274,155 common shares at $0.50 per share were issued in January, 1987 for cash.

(ii) A $700,000 loan payable on demand, bearing interest at 12% per annum, to finance future capital expenditures was received in September, 1987. Interest of $24,625 was paid in 1987.

(iii) 1,251,929 common shares at $1.40 per share and working interests in certain oil and gas properties were exchanged for royalty interests in oil and gas assets in October, 1987.

(iv) Royalty payments of $480,545 were made in 1987.

(v) Management fees totalling $181,209 were received during 1987.

9. Subsequent Events

(i) 21,430 common shares were issued at $0.70 per share to two senior officers in February, 1988 for services rendered.

(ii) The Board of Directors approved the sale of fixed assets to the Inuvialuit Petroleum Corporation for proceeds of $3,018,000 on May 2, 1988 subject to certain regulatory, lender and shareholder approvals. The proceeds of the sale will be applied to retire debt of the Company. The ceiling limitation calculation has been applied to capitalized costs net of the proceeds of this sale and compared to future net revenues excluding those relating to this sale (Note 2).

CORPORATE INFORMATION

BOARD OF DIRECTORS

Robert A. Brown (C)
Calgary, Alberta

Peter T. Coolican (C) (*)
Ravenna, Ontario

P. Douglas McArthur
Calgary, Alberta

Russell A. Newmark
Tuktoyaktuk, N.W.T.

James L. Rathwell (*)
Red Deer, Alberta

Kenneth A. Robinson (C)
High River, Alberta

Graham D. Ross (*)
Calgary, Alberta

Dr. A. Pedro H. Van Meurs
Calgary, Alberta

(C) Members of the Compensation Committee
(*) Members of the Audit Committee

SENIOR OFFICERS

Dr. A. Pedro H. Van Meurs
Chairman of the Board

P. Douglas McArthur
President

Keith J. Bohlken
Vice President
Exploration & Production

J. Allan Taylor
Treasurer & Secretary

KNEE HILL OFFICE

#400, 505 - 8th Avenue S.W.
Calgary, Alberta T2P 1G2
Telephone: (403) 262-6955
Fax: (403) 266-4833

TRANSFER AGENT

Central Trust Company
Corporate Trust Dept.
c/o Guaranty Trust
401 - 9th Avenue S.W.
Calgary, Alberta T2P 3C5
Telephone: (403) 292-1000

LEGAL COUNSEL

MacKimmie Matthews
700, 401 - 9th Avenue S.W.
Calgary, Alberta T2P 2M2
Telephone: (403) 232-0639

AUDITORS

Thorne Ernst & Whinney
1200 Bow Valley Square 2
255 - 5th Avenue S.W.
Calgary, Alberta
Telephone: (403) 262-0100

BANKERS

Canadian Imperial Bank of Commerce
Corporate Banking Centre
Oil and Gas Department
7th Floor, 505 - 5th Street S.W.
Calgary, Alberta T2P 2P2
Telephone: (403) 267-4021

STOCK EXCHANGE LISTING

Alberta Stock Exchange
Symbol: KHC

KHC KNEE HILL ENERGY CANADA LTD.
400, 505 - 8th Avenue S.W.
Calgary, Alberta T2P 1G2
Telephone: (403) 262-6955 Fax: (403) 266-4833

MCARA PRINTING LIMITED
Calgary, Alberta, Canada